Internal Revenue Service

memorandum

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Br1:HMLewis

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to: District Counsel, Honolulu, HI CC:HON

from: Director, Tax Litigation Division CC:TL

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subject: [redacted]

This is in response to your memorandum dated December 21, 1987, requesting technical advice with respect to the above-named taxpayer.

ISSUE

Whether the application of I.R.C. §§ 707(b)(2)(A) and 267(c) prevents [redacted] ([redacted]), a general partnership, from reporting the gain on a sale of [redacted] to [redacted] ([redacted]) as long term capital gain. 0707-0202

CONCLUSION

(1) [redacted] is not a partner in [redacted]. Therefore, section 707(b)(2)(A) is not applicable and does not prevent [redacted] from reporting the gain in question as long term capital gain.

(2) Even if [redacted] could be deemed a partner in [redacted] for purposes of section 707(b)(2)(A), [redacted]'s constructive ownership of [redacted] never reaches 80 percent as required by that section. Therefore, the limitation imposed by section 707(b)(2)(A) is not applicable.

FACTS

On [redacted], [redacted] sold its leasehold interests in [redacted] and [redacted] to [redacted], a corporation. On that date, [redacted] had [redacted] partners. [redacted] had a [redacted] percent interest in [redacted]; [redacted] had a [redacted] percent interest; and [redacted] had a [redacted] percent interest. [redacted] is the [redacted].

[redacted], a limited partnership, was formed [redacted], to facilitate the purchase of various interests in [redacted] from the [redacted] group. [redacted] purchased a [redacted] percent interest in [redacted] on [redacted], and a [redacted] percent interest on [redacted].

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On [redacted], [redacted] owned a [redacted] percent partnership interest in [redacted]; [redacted] owned a [redacted] percent interest; [redacted] owned a [redacted] percent interest; and it appears that the remaining [redacted] percent interest was owned by [redacted].

On [redacted], [redacted] owned approximately [redacted] percent of the stock in [redacted]. The remaining stock appears to be owned by [redacted].

ANALYSIS

Section 707(b)(2)(A) 1/ provides that in the case of a sale or exchange, directly or indirectly, of property, which in the hands of the transferee, is property other than a capital asset as defined in section 1221 between a partnership and a person owning, directly or indirectly, more than 80 percent of the capital interest, or profits interest, in such partnership, any gain recognized shall be considered as ordinary income.

Treas. Reg. § 1.707-1(b)(3) provides, in part, that in determining the extent of the ownership by a partner, as defined in section 761(b), of his capital interest or profits interest in a partnership, the rules for constructive ownership of stock provided in section 267(c)(1),(2), (4), and (5) shall be applied for the purpose of section 707(b) and this paragraph. Under these rules, ownership of a capital or profits interest in a partnership may be attributed to a person who is not a partner as defined in section 761(b) in order that another partner may be considered the constructive owner of such interest under section 267(c). However, section 707(b)(1)(A) does not apply to a constructive owner of a partnership interest because he is not a partner as defined in section 761(b).

Section 761(b) and Treas. Reg. § 1.761-1(b) provide that for purposes of subtitle A of the Code, the term "partner" means a member of a partnership.

[redacted], a partnership, sold its leasehold interests in the [redacted] to [redacted], a corporation. In order for section 707(b)(2)(A) to apply to this transaction, it must be determined that there was a sale between a partnership and a partner that owns more than an 80 percent interest in the partnership. Thus, the first issue is whether [redacted] is a partner in [redacted].

1/ For purposes of this memorandum, all references to Code provisions are with respect to the law that was in effect in [redacted].

The information submitted indicates that [redacted] has [redacted] partners. They are [redacted], [redacted], and [redacted]. [redacted] is not a partner of [redacted]. Therefore, the sale between [redacted] and [redacted] is not subject to section 707(b)(2)(A).

On page three of the District Counsel memorandum, dated December 18, 1987, it is stated, "It does not appear to be disputed that [redacted] is deemed to be a partner of [redacted] for purposes of application of I.R.C. § 707(b)(2)(A)."

However, we are not aware of any statutory or regulatory authority that makes [redacted] a partner in [redacted]. The fact that [redacted] is a partner in [redacted], which is a partner in [redacted], does not make [redacted] a partner in [redacted].

Treas. Reg. § 1.707-1(b)(3) provides certain constructive ownership rules for determining the ownership by a partner, as defined in section 761(b), of his capital or profits interest in a partnership. (emphasis supplied) Section 761(b) does not contain any deemed partner provision that makes [redacted] a partner in [redacted].

The second sentence of Treas. Reg. § 1.707-1(b)(3) provides that ownership of a capital or profits interest in a partnership may be attributed to a person who is not a partner as defined in section 761(b) in order that another partner may be considered the constructive owner under section 267(c). (emphasis supplied) However, this constructive ownership provision does not make a person who is not otherwise a partner as defined in section 761(b) a partner. It attributes the nonpartner's ownership interests to another that is a partner.

In a discussion concerning the second sentence of Treas. Reg. § 1.707-1(b)(3), W. McKee, W. Nelson, and R. Whitmire, Federal Taxation of Partnerships and Partners, paragraph 13.04[2], at 13-37 (1977), state the following:

> In contrast §§ 707(b)(1)(A) and 707(b)(2)(A) refer to sales between a partnership and a "partner" who owns a specified interest in partnership capital and profits. The use of the word "partner" in these sections precludes their application to sales between a partnership and a person who is not an actual partner, as defined by § 761(b), even though the constructive ownership rules may attribute a substantial capital profits interest to the person dealing with the partnership. 114

> 114 See Reg. § 1.707-1(b)(3), which specifically states that § 707(b)(1)(A) (relating to the disallowance of losses on sales or exchanges between a partnership and a controlling partner) has no application to sales or exchanges between a partner and a nonpartner who is attributed ownership of a partnership interest under § 267(c). Although this regulation does not apply, by its terms, to gain transactions between partnerships and nonpartners under § 707(b)(2)(A), the language of the two sections is parallel, and they should be interpreted consistently in this regard.

Therefore, because [redacted] is not a partner in [redacted], the sale between [redacted] and [redacted] is not subject to the limitation imposed by section 707(b)(2)(A). In making the determination that [redacted] is not a partner in [redacted], we have applied the entity theory of partnerships.

Rev. Rul. 87-51, 1987-26 I.R.B. 20, states:

> Under the provisions of subchapter K of the Code, a partnership is considered for various purposes to be either an aggregate of its partners or an entity, transactionally independent of its partners. Generally, subchapter K adopts an entity approach with respect to transactions involving partnership interests. See Rev. Rul. 75-62, 1975-1 C.B. 188. Whether an aggregate or entity theory of partnerships should be applied to a particular Code section depends upon which theory is more appropriate to such section. See S. Rep. No. 1622, 83rd Cong., 2d Sess. 89 (1954) and H.R. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954); Casel v. Commissioner, 79 T.C. 424 (1982).

Section 707 applies to certain transactions between a partner and a partnership. Thus, the intent is to view the partner as separate from the partnership. Because section 707 is generally an entity-oriented provision, an entity approach is more appropriate for section 707(b)(2)(A). In W. McKee, supra p. 3, paragraph 1.02[3], at 1-6 (1977), it is indicated that section 707 adopts the entity theory.

However, if we assume that the correct approach in section 707(b)(2)(A) is the aggregate theory, [redacted] would be a partner in [redacted]. The issue would be whether [redacted] owns, directly or indirectly, 80 percent of the capital interest of profits interest in [redacted].

The application of the constructive ownership rules of Treas. Reg. § 1.707-1(b)(3) gives [redacted] a [redacted] percent ([redacted] percent of [redacted]) interest in [redacted]. This falls short of the required 80 percent interest.

On page four of your memorandum, you state that [redacted]'s [redacted] percent interest may be attributed "downstream" to [redacted] and [redacted], who constructively own [redacted] percent of [redacted]. Under this analysis, the sale of the [redacted] to [redacted] would be treated as a sale to a partner ([redacted] and/or [redacted]) who indirectly owns [redacted] percent of the capital and profits interest in [redacted].

Although [redacted] and [redacted] may be deemed to own [redacted] percent of [redacted] under the rules of Treas. Reg. § 1.707-1(b)(3), that does not mean that [redacted] is deemed to own more than 80 percent of [redacted]. The constructive ownership rules of Treas. Reg. § 1.707-1(b)(3) and the applicable provisions of section 267 do not attribute ownership to a corporation from its shareholders. (There are such attribution rules but they are not applicable in this case. For example, see section 318).

Accordingly, even if the aggregate theory is used to make [redacted] a partner in [redacted], [redacted]'s ownership in [redacted] never reaches the 80 percent test required by section 707(b)(2)(A).

We would like to point out that the purchase by [redacted] of a [redacted] percent interest in [redacted] on [redacted], and a [redacted] percent interest on [redacted], is a sale of a [redacted] percent interest in [redacted] within a [redacted]-month period. Therefore, under section 708(b)(1)(B), there is a termination of the partnership on [redacted].

Treas. Reg. § 1.708-1(b)(1)(iv) provides that if a partnership is terminated by a sale or exchange, the following is deemed to occur. The partnership distributes its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properites; and, immediately thereafter, the purchaser and the other remaining partners contribute the properites to a new partnership, either for the continuation of the business or for its dissolution and winding up.

Thus, for tax purposes, the old partnership is terminated and a new partnership is formed. In addition to the closing of the old partnership's taxable year, the termination and recontribution may require adjustments to the purchasing and other remaining partners' bases in partnership assets and interests and may require recapture of any investment credit.

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